



Australian Government  
Department of Foreign Affairs and Trade



# Framework for supporting tax policy and administration through the aid program

*March 2016*

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## Purpose

**This framework aims to guide Australia's approach to assisting partner governments to achieve their tax policy and administration goals.**<sup>1</sup> The framework should be read in conjunction with the Effective Governance Strategy.<sup>2</sup>

**A sustainable revenue base is a prerequisite for resilient and sustained economic growth.** Domestic tax revenue provides a foundation on which governments can plan their recurrent expenditure, make investments in essential infrastructure and institutions, and encourage job growth. In addition, an efficient and well-administered tax system is important for state-building and sends a message about the overall quality of governance in a country. This, in turn, can contribute to creating an enabling environment for the private sector to flourish and is conducive to attracting global investment. Support for this process is consistent with Australia's aid framework, which identifies a role for the aid program in developing the capacity of countries to mobilise domestic resources.<sup>3</sup>

**Taxation is central to the relationship between citizens and the state.** The role of the state in revenue collection helps establish an accountable, responsive and ultimately legitimate state. In the case of fragile states, the over-reliance on natural resources or foreign aid for revenue has raised questions on whether a stronger focus on domestic taxation could lead to a "governance dividend".<sup>4</sup> For this reason, an investment in broadening a country's tax base can be worthwhile even where it does not yield large or immediate revenue gains.

**The Third International Conference on Financing for Development in July 2015 recognised that increased Domestic Resource Mobilisation (DRM) will be integral to financing the Post-2015 Development Agenda.** In recognition of this, Australia is a founding member of the Addis Tax Initiative (ATI), which will support developing countries to strengthen their tax systems, increase their domestic resource mobilisation, and promote stronger economic governance.

**The ATI commits Australia to doubling its investments to support tax systems in developing countries by 2020.** In 2013-14, 0.3 per cent or \$15.7 million of Australia's official development assistance (ODA) was used to fund DRM-related activities across a range of programs.

## Context

**Tax revenue provides governments with the funds necessary to deliver public services, make investments, and relieve poverty.** Secure and adequate tax revenue allows governments to plan their expenditure and reduce their reliance on external sources of finance, including aid and loans. Developing countries have made great progress in expanding their tax revenue over time, but more can be done.

**Over the period 2000 to 2011, there was a four-fold expansion in general government revenues in all emerging and developing economies (from US\$1.5 trillion to US\$7 trillion).** The International Monetary Fund (IMF) forecasts that this growth in government revenues will continue and will reach US\$10.7 trillion in 2017. Figure 1

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<sup>1</sup> This framework focusses on tax policy and administration, but domestic resource mobilisation (DRM) encompasses a broader range of issues, including building and maintaining a sustainable tax base (through both domestic and international reforms), raising non-tax government revenues, and mobilising financial resources of domestic households and firms.

<sup>2</sup> DFAT (2015)

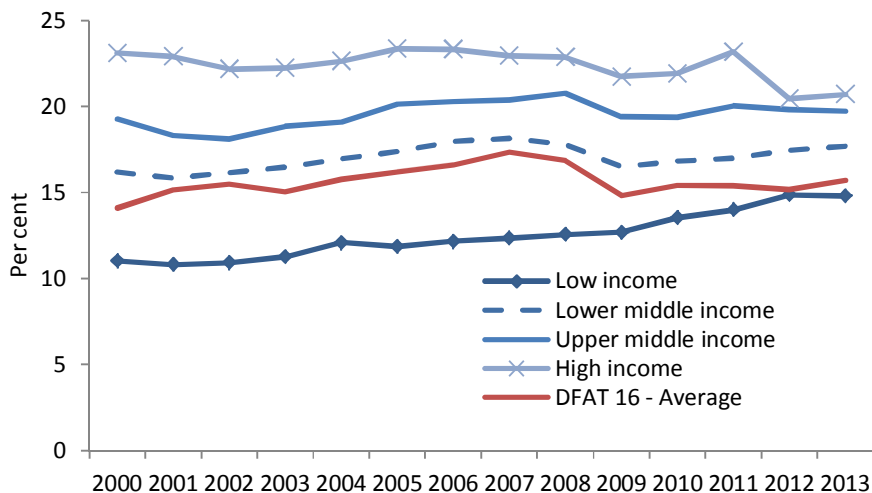
<sup>3</sup> DFAT (2014) p.2

<sup>4</sup> OECD (2014b); Carnahan (2015)

illustrates changes in tax revenue as a per cent of gross domestic product (GDP) from 2000 to 2013. Low-income countries, in particular, had significant gains in revenue over this time – albeit from a low base. Lower middle-income countries, on the other hand, appeared to end the period approximately where they started in terms of their tax ratios.

The tax and development literature quotes a minimum tax to GDP benchmark of 15 per cent to deliver essential public services. Many of Australia’s Asian partner countries in particular fall below this threshold (Figure 2).<sup>5</sup>

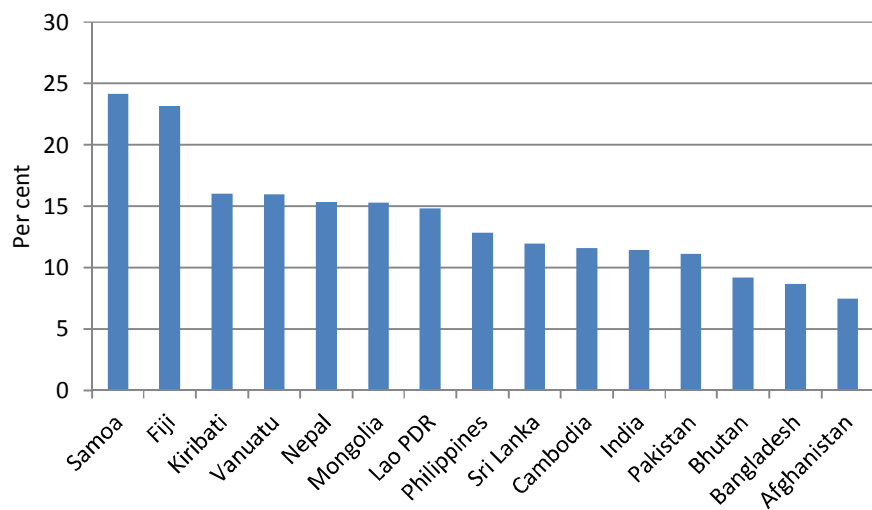
Figure 1: Tax revenue as a per cent of GDP, 2000-2013



Sources: IMF FAD, ICTD, ADB.

Note: DFAT 16 includes Fiji, Kiribati, Nauru, PNG, Samoa, Solomon Islands, Tonga, Vanuatu, Afghanistan, Myanmar, Cambodia, Indonesia, Lao PDR, Philippines, Timor-Leste and Vietnam.

Figure 2: Tax revenue as a per cent of GDP (2012)



Sources: World Development Indicators. Data for Samoa from IMF Article IV Consultation.

Note: Data from Nepal and Pakistan are for 2013, from Bangladesh and Vanuatu are for 2011, from Bhutan and Indonesia are for 2009 and from Fiji are for 2006.

<sup>5</sup> Originally discussed in IMF (2005) but widely referenced in more recent literature.

## **Principles and Approaches**

Tax policy and administration reform are highly political and can be impeded by deep vested interests. Winners and losers in tax reform can be clearly identified in some instances, and this opens opportunities to apply political pressure against reform. In other cases, while the benefits of reform may increase over time, there can be significant administrative and compliance costs in the short term.<sup>6</sup> The risk of corruption is particularly high in relation to tax administration. Tax law is complex and tax officials can have a high degree of discretion in their application of tax powers.<sup>7</sup> All of these factors combine to highlight the importance of deep and quality analysis prior to investing in tax related assistance. In the case of many developing countries, one of the limitations in undertaking such analysis can be a shortage of data.

While there are risks to both developing country governments and donors seeking to reform tax policy or administration, these should be balanced against the benefits of increasing the capacity of developing countries to finance their own development and to set affordable long-term priorities.

**To support effective investments in tax policy and administration assistance DFAT will adopt the following approach:**

1. **Underpin investments with thorough political and economic analysis.** This will start with an understanding of a partner government's objectives and detailed political and economic analysis of tax policy and administration, and the constraints on and opportunities for reform. This analysis is critical to decisions relating to the appropriateness of an investment including its focus (for example, policy, administrative or both), the mode of assistance, and the appropriate delivery partner.
2. **Prioritise working with partner governments to strengthen their revenue to GDP ratios and the fairness and sustainability of their tax systems** through increasing support for tax-related assistance, and facilitating access to relevant expertise by partner governments.
3. **Promote international tax norm-setting processes that engage with developing countries in the Indo-Pacific region.** The Australian Government should use engagement in international tax norm-setting processes to advocate for norms that promote the inclusion and engagement of developing partner countries in the Indo-Pacific region.
4. **Advance policy coherence on tax issues across Australia's domestic and international policy spheres.** DFAT will continue to engage with other Australian Government departments to consider the implications for Australia's partner countries of Australian and international tax policies, and promote international tax cooperation to benefit partner countries and Australia alike.

Underpinning DFAT's principles and approaches to tax-related assistance is the Australian commitment to the Addis Tax Initiative (ATI). Australia agreed to the ten key principles of the ATI (Box 1).

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<sup>6</sup> Carnahan (2015)

<sup>7</sup> Bridi (2010)

**Box 1: Principles of ATI**

1. We affirm that each country has primary responsibility for its own economic and social development, and that the role of national policies, development strategies and resources is critical.
2. We acknowledge the importance of all sources of development finance, including ODA, which remains critically important, especially for the poorest developing countries that have limited capacity to raise resources, and for key sectors like education, health and other social sectors where need is greatest.
3. We recognise that domestic resources have been the most rapidly growing component of development financing this decade, and that greater mobilisation of domestic resources is essential to achieving the goals of the Post-2015 Development Agenda.
4. We will apply a holistic approach to domestic revenue mobilisation, encompassing both mobilisation and management of domestic public resources, while respecting national policies and strategies, noting that success depends on both raising domestic revenues, and channelling those resources toward effective public services that enable countries to achieve the goals of the Post-2015 Development Agenda.
5. Since rapid growth and structural economic transformation is critical for enhancing domestic revenue in developing countries, partners in this initiative will support these countries' endeavours to diversify their economies.
6. We embrace policies and practices that foster fair, efficient and transparent tax systems, and effectively allocate the equitable distribution of tax burdens and benefits. Taxpayer morale and confidence, being essential to effective domestic resource mobilisation, promoting effective and equitable delivery of services and fair, consistent and impartial treatment of taxpayers in the application of the law, is paramount.
7. We agree to modernise tax systems and to provide high-level political support and demonstrated commitment to strong domestic governance and institutions necessary to unlock substantial new domestic resources for development.
8. We agree to enhance cooperation to combat tax evasion, fight corruption, tackle illicit finance, and promote good financial governance, transparency and accountability.
9. We will measure progress on domestic revenue mobilisation, and develop and track country specific indicators and targets for revenue collection and other aspects of tax system performance.
10. We will encourage broad-based dialogue that includes the private sector, civil society, and other stakeholders to build coalitions for reform and ensure better ownership, implementation and accountability.

## **Underpin investments with economic and political analysis**

**The decision on whether to prioritise assistance must be made in the context of a deep understanding of the political economy related to domestic resource mobilisation.** Understanding the political economy driving tax policy and administration is a critical first step when considering support for their improvement.

**Political economy analysis can help demarcate the boundaries of possible reform.** In the event that political economy analysis concludes that there is no appetite or capacity for policy reform it may still be possible to make progress in relation to administrative reform. Identifying possible benefits from different reform options through detailed analysis might also create appetite for policy reform to occur in the future.

**Strong political economy analysis can also help manage the risks associated with tax policy and administration investments.** Risks can be managed through active consideration of the mode, design and deliverer of assistance. In the case of tax policy reform, for example, it may be that advice is best delivered through an international organisation such as the International Monetary Fund, the Organisation for Economic Cooperation and Development (OECD) or the World Bank Group rather than through Australian Government officials, or other aid-funded advisers.

## **Prioritise work with partner governments to strengthen their tax revenue to GDP ratios and the fairness and sustainability of their tax systems**

**Reforming tax policy and administration is closely linked to the broader agenda of budgeting and public expenditure management.** There is no doubt that citizens' willingness to pay tax is influenced by perceptions of the quality of public goods and services that the government provides. Citizens and firms can be less willing to pay tax when there is a lack of state legitimacy, or a perception of corruption and misuse of public funds. Donors also may legitimately question the value of assisting a government to generate additional revenue if the government has a poor record in public expenditure management. Nevertheless, in such situations, there may still be value in supporting reforms that do not raise revenue but support some of the other positive linkages between tax and improved governance. Revenue-neutral reforms can improve the efficiency of the tax system, promote equity, and reduce compliance and administrative costs. Box 2 provides examples of policy reforms that can contribute to better governance outcomes.

### **Box 2: Examples of tax policy reforms that promote better governance**

- Broadening the tax base and lowering rates
- Eliminate or scale back tax concessions that benefit special interests
- Increase transparency of tax concessions
- Establish simple and fair fees/taxes for micro and small enterprises to reduce barriers to formalisation
- Promote entry to the Extractive Industries Transparency Initiative (EITI)
- Develop capacity for tax policy analysis
- Strengthen local government revenue streams in ways that include simple and more effective use of property taxes and license fees
- Assist government with policy and legislative reforms to address Base Erosion and Profit Shifting (BEPS) through the BEPS Action Plan
- Assist governments to make the legislative and regulatory changes necessary to implement the Automatic Exchange of Information for Tax Purposes.

Source: Based on ITC 2013, p.30.

**Tax policies and administration can have unintended consequences on other development objectives, such as gender equality.** For example, income tax policies can hinder efforts to increase women's labour force participation by reducing the payoff for women returning to work. Other effects can be more subtle. Whole-of-household tax returns might reduce administrative burdens on taxpayers, but they often disadvantage the lower income earner in the household, through the application of a higher marginal tax rate. Significant differences in the consumption patterns of men and women can also cause the tax burden from indirect taxes such as VAT to fall more heavily on one gender than the other.<sup>8</sup> It is therefore important that any tax reform effort considers the impact on disadvantaged groups, as well as on income distribution more broadly. This is particularly important in a developing country context where the need to balance simplicity in administration can, to an extent, drive the choices that are made in relation to tax policy.

**Simplifying tax legislation and improving revenue administration are closely linked, and should be considered together.** Administrative reform can improve the efficiency of tax collection, promote equity, or reduce compliance and administrative costs. Some of the most common areas of tax administration reform include increasing the autonomy of the revenue collection agency, moving towards function-based organisational arrangements, and establishing offices for different categories of taxpayers – in particular, large taxpayer units. There has also been a focus on modernising technology systems and simplifying collection. Box 3 identifies some options for tax administration assistance.

**Box 3: Options for tax administration assistance**

- Professionalising tax administration through remuneration reform, merit-based human resource management and training
- Strengthening revenue forecasting and monitoring capacity
- Introducing more effective integrity and internal audit programs to control abusive and corrupt practices
- Modernising information technology systems to improve operational efficiency and reduce discretionary interactions with taxpayers
- Organising tax operations around customer lines to improve service and efficiency
- Introducing systems for voluntary compliance
- Strengthening a culture of customer service in the tax administration
- Developing greater transparency in relation to tax systems and tax data
- Designing public information campaigns on taxpayer rights and responsibilities
- Introducing electronic filing and payment, and simplifying forms, particularly for micro and small enterprises
- Strengthening procedures for appeals
- Improving institutions such as business and property registries and tax appeals courts.

Source: Based on ITC 2013, p.30.

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<sup>8</sup> GTZ (2015)



## **Promote international tax norm-setting processes that engage with developing countries in the Indo-Pacific**

**Australia engages in international forums to influence global tax policy and administration.** This engagement aims to better identify and mitigate global risks such as cross border tax evasion or avoidance, champion international transparency and equitable tax administration, enhance Australia's commitment to supporting regional development, and create strong partnerships with key emerging countries. To feed into OECD and G20 decisions in relation to global norms on taxation, DFAT works with the Australian Treasury and the Australian Taxation Office (ATO) to identify approaches that will build integrity in the global tax system, and are achievable in a developing country context. A recent example was work undertaken in the context of Australia's presidency of the G20 in 2014, where the three government agencies worked with the Global Forum on Transparency and Exchange of Information for Tax Purposes to deliver on a G20 request for a roadmap for developing country implementation of Automatic Exchange of Information for Tax Purposes (AEOI).

## **Advance policy coherence on tax issues across Australia's domestic and international policy spheres**

**Working closely across Australian Government agencies on issues related to tax policy and administration is essential.** Australia's domestic tax laws and administration can impact on Australia's developing country neighbours. In addition, staff in the Australian Treasury and the ATO have the relevant skills and expertise needed to inform assistance for tax policy and administration reform.

**It is in Australia's interest to work with partner governments to strengthen the region's capacity to target international tax evasion.** The key international tax themes affecting Australia's tax system and economy include base erosion and profit shifting (BEPS), and international tax transparency. Successfully addressing these issues cannot be achieved unilaterally. Poorly functioning administrations, particularly within the Indo-Pacific region, become targets for offshore tax evasion, tax crimes and harmful tax practices. Australia's efforts to build capacity and capability in the revenue agencies of developing countries helps ensure that the correct amount of tax is collected by each jurisdiction, including Australia.

**The international tax agenda has the potential for strong alignment between the objectives of developed and developing countries** and the benefits of regional and global cooperation on international taxation arrangements can flow both ways. Box 4 outlines key issues in international tax.

**In a domestic context, DFAT can raise awareness about possible negative spillovers<sup>9</sup> for developing countries of both domestic and international tax policy and administration.** It can also bring an informed perspective across government on domestic and international tax issues based on feedback received through its network of posts and contacts with businesses overseas.

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<sup>9</sup> Decisions about taxation policy in one country can impact on other jurisdictions resulting in "spillovers". These spillovers may negatively affect international capital flows, and corporate and income tax bases. In some cases, changes in one country's policies can trigger excessive tax competition (in which countries compete to lower their tax rates to attract foreign investment), which in its extreme form can result in a "race to the bottom" where less revenue is collected overall (IMF (2014)).

#### Box 4 Key international tax issues

**As a basic principle, individuals and companies should pay tax where economic activity takes place, and governments should design tax systems that achieve this objective.** This objective is more easily achieved when goods are produced entirely within a single country. However, it is more difficult in an increasingly globalised and service-based economy where economic activity occurs across national borders. As a result, international tax issues are attracting increased attention from policymakers. Global policymakers have focused on two broad types of taxation issue: tax avoidance by multinational enterprises and tax evasion by individuals. Underlying both issues are the opportunities and incentives for companies and individuals to structure their business and personal affairs to exploit differences between national tax systems to reduce their total tax bill. Some countries (usually those with relatively lower tax rates) benefit from this activity while others suffer from a reduction in their tax base. In aggregate, this activity leads to less revenue collected globally.

**Illicit financial flows (such as money laundering, tax evasion and international bribery) represent a major loss to developing countries' domestic resource base, comprising an estimated US\$991 billion in 2012.** Fragile and conflict-affected states are particularly vulnerable to illicit financial flows, as authorities often lack the capacity and legitimacy to target illegal activities that lead to them. Global Financial Integrity estimates that trade mis-invoicing – deliberately understating the value of a transaction to customs authorities to avoid tax or other charges – represents 80 per cent of illicit financial flows. A number of international mechanisms are in place to support developing countries to track and recover large illicit transactions. However, there is significant scope to bolster the capability of tax officials in developing countries to identify more routine tax evasion and to recover lost revenue.

Sources: OECD (2013), Kar and Spanjers (2014).

### Learning from past investments to build a stronger understanding of tax policy and administration issues and assistance

DFAT has historically managed a series of bilateral and regional tax-related programs. While the experience of each project is country- and context- specific, it is possible to draw out some common lessons from Australia's DRM investments, including:

- > **Sensitivity to political economy factors:** Tax policy and administration are highly technical fields, but purely technical 'fixes' can be counterproductive if they ignore the wider context. Political sensitivities around tax policy reform must be managed carefully, while internal dynamics within national revenue authorities – including corruption, poor human resources policies, aggressive or abusive collection and compliance procedures, and inadequate or misallocated resources – can compromise the effectiveness of supported tax policy and administration programs.<sup>10</sup>
- > **Long-term commitment:** While discrete tax policy projects can be supported through short-term technical assistance, broader tax administration capacity building requires long-term, sustained commitment. A targeted short-term surge of project-oriented assistance can be extremely effective, but a long-term presence is necessary in order to develop trusted networks and to quickly identify and exploit these short-term reform opportunities as they arise. Accordingly, several of Australia's DRM investments – including in the Pacific Financial Technical Assistance Centre, the *Strongim Gavman*

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<sup>10</sup> ITC (2013)

Program in Papua New Guinea, and the Australia Indonesia Partnership for Economic Governance and the Government Partnerships Fund – use a combination of long-term (resident Lead Advisors) and short-term (training, two-way exchanges and short-term technical advisors) components.

Institutional capability building is an incremental process and it is important to ensure stable long-term planning, implementation arrangements and funding levels. Australia's tax administration work in Indonesia has been underway since 1999 and provides a good example of a long term commitment to institutional strengthening.

- > **Monitoring and Evaluation (M&E):** Tax administration reforms and capacity building are long-term endeavours and their outcomes can be incremental and difficult to observe. Changes in revenue collected, taxpayer registration and other easily measureable targets can be poor proxies for the success or failure of institutional capacity-building efforts. It can also be difficult to attribute particular outcomes to a given investment where the host revenue authority is pursuing other reforms in parallel or where several development partners are involved in separate DRM projects with the same organisation. As a result, an effective M&E framework must be based on an agreed set of performance targets and M&E benchmarks that focus on substantive outcomes rather than inputs, activities or outputs. The framework should be clearly communicated to implementing partners in situations where DFAT has limited exposure to the day-to-day implementation of supported activities.
- > **Producing sustainable outcomes:** An investment is more likely to be sustainable when:
  - » the objectives and activities of the investment align with those of the partner revenue authority
  - » there is pressure within the partner country to reform, such as fiscal pressure, pressure to comply with international norms, or high level political pressure
  - » the objectives and activities of the investment balance the need to quickly increase efficiency (such as through an increased role for advisors or by outsourcing some tax functions) with a long term goal of improving the capability of the revenue authority
  - » the revenue authority has the capacity to absorb support and retain technical advice and training – staff turnover and low retention rates can compromise capability-building efforts.
- > **Selection of advisors:** advisors – particularly those selected for long-term placements to work inside national revenue authorities – should be assessed and selected according to several criteria. These can include: cultural sensitivity, management skills, their ability to train and work with local counterparts, and their technical competence. Local consultants can be very helpful in providing local knowledge, overcoming internal resistance and building collaborative relationships. Their contribution to a project is greatest when there is trust and communication with the Lead Advisor.

## **Available resources for program areas considering an investment in tax policy or administration support**

This framework reflects a new, increased emphasis on tax-related assistance within Australia's aid program. This section outlines some of the internal and external resources available to DFAT staff to help decision making in relation to possible tax-related programming. Staff can:

- > **Access DFAT good practice notes for practical advice** on identifying the potential for tax-related assistance, questions to guide political economy analysis and a range of background papers on aspects of taxation in developing countries.
- > **Access external resources.** International organisations such as the IMF, World Bank Group, OECD and the United Nations (UN) all work on taxation issues in developing countries. There are a range of assessments and diagnostic tools utilised by these organisations that can help identify areas in DRM that may benefit from capability building or reform.
- > **Ask for assistance in identifying, designing or evaluating tax-related assistance.** Assistance can be provided to identify the tax policy and administration challenges faced by partner countries, identify opportunities for investment, and participate in different parts of the program cycle. The Development Economics and Tax section can also facilitate engagement with relevant international organisations providing tax-related assistance.

## **Monitoring progress in Australia's assistance for tax policy and administration reform**

**DFAT will monitor progress against the ATI to double tax-related assistance by 2020.** Australia will voluntarily report activities under a new metric introduced by the Development Assistance Committee (DAC)<sup>11</sup> to help donors analyse their support to revenue policy and administration.

**DFAT's tax-related programs, like other programs, will need to establish performance monitoring frameworks that aim to measure outcomes** — and these should refer to the DFAT aid programming guide and the Effective Governance Performance Assessment Note. In designing a performance monitoring framework for tax policy and administrative assistance programs, it is important to remember that, while increased revenue is often a key objective, tax reforms should meet other criteria. These might include fairness and sustainability, and more equitable distribution of public resources, especially for women. Indicators of success could include, for example, evidence of a broader tax base or faster processing times. In all cases, performance monitoring frameworks should include information about how to measure and assess progress against the desired outcomes of the program.

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<sup>11</sup> There are 29 member countries in the DAC including Australia.

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